Weekly Geopolitical Report

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October 28, 2019

Japan: Will the Tax Hike Bite? Part I

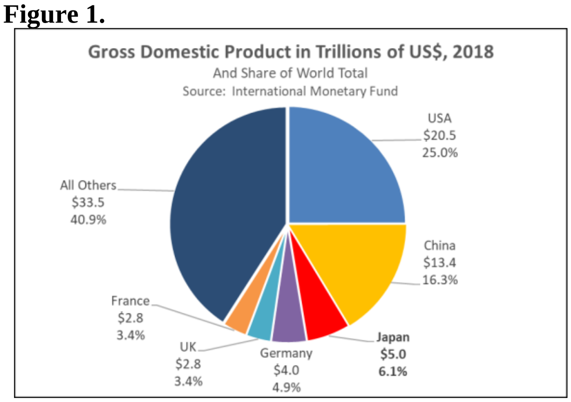
Even though Japan has one of the world's largest economies and accounts for a hefty share of global stock market capitalization, it isn't getting nearly as much attention from investors as it did during its boom years in the 1970s and 1980s. In part, that's because Japan's economic growth has become slower and more erratic ever since its stock bubble imploded in 1989. Inflation has become worrisomely low, prompting a range of radical fiscal and monetary policies.

Some of Japan's biggest slowdowns have started with tax hikes, so investors are now worried what will happen after a boost in the value-added tax (VAT) is implemented on October 1. Since it looks like Japan will weather the new tax hike well, it may be a good time to review the recent developments in the Japanese economy and explain why this tax hike doesn't seem to be causing problems. Part I of this report will provide a primer on the current Japanese economy and financial markets. Next week, in Part II, we will focus on Japan's geopolitical and domestic priorities, the reasons for the new VAT hike and ramifications for investors.

Japan's Place in the Global Economy

Japan's 126.2 million people are responsible for a significant share of global economic activity. As shown in Figure 1, the country's gross domestic product (GDP) totaled some $5.0 trillion in 2018, ranking it third in the world after the United States and China. The Japanese are also among the world's richest people. Adjusting for the purchasing power of the currency, Japan's per-capita GDP stood at $44,200 in 2018, or 70.6% of the U.S. level. Workers in the service industries generate the vast majority of Japan's GDP, as is typical for highly advanced countries. According to the World Bank, services accounted for 69.1% of Japanese GDP in 2018, while industry (manufacturing, construction, mining, etc.) accounted for approximately 29.1%.

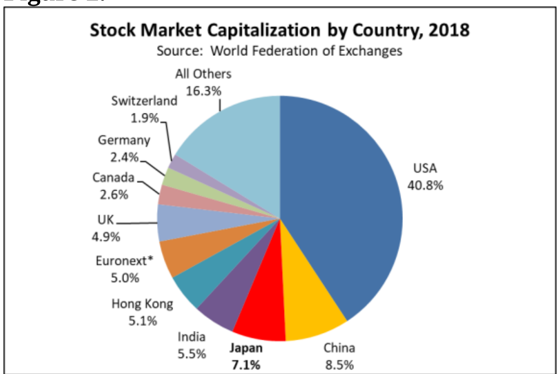
Figure 1.



For investors, the key questions are how competitive is Japan's economy, and how attractive are its capital markets? The World Economic Forum currently ranks Japan as the sixth most competitive economy globally, owing largely to its high-quality workforce and stable macro-economic environment. That puts Japan just one notch below Switzerland and one above Germany. Although Japan's economy is dominated by services, its international competitiveness can be discerned by looking at which of its goods-producing industries are most dominant in global exports. Data from the U.N. International Trade Center suggests that Japan's most competitive industry is Photographic Goods, where the country's firms account for 29.4% of all global exports. Its second most competitive industry is Autos and Auto Parts at 10.6% of world exports, and its third most competitive industry is Ships at 10.4%.

Japan's financial markets are similarly well developed and large, offering investors multiple opportunities to participate in the fortunes of Japanese companies. As shown in Figure 2, the country accounted for 7.1% of total world stock market capitalization at the end of 2018, ranking it third largest.

Figure 2.



Reflecting Japan's leading position among non-U.S. developed country stock markets, Japanese stocks represented 16.5% of the MSCI All Cap World Index Ex-U.S. at the end of September 2019. As listed in Table 1, the top Japanese sectors are currently Industrials, Consumer Discretionary and Information Technology.

Table 1.

Stock Market Structure, September 2019
Source: MSCI.com

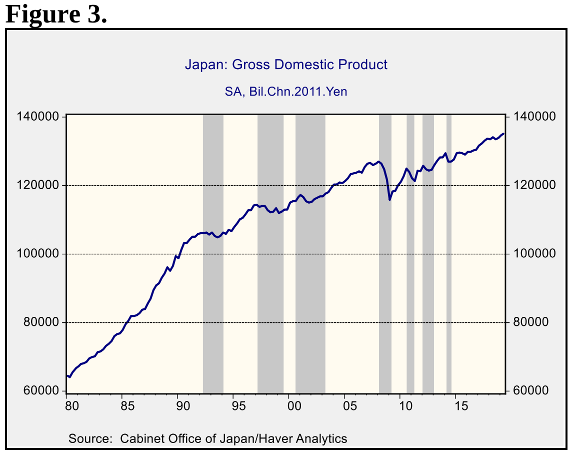
Sector	MSCI Japan Index (%)	MSCI USA Index (%)	Over / (Under) USA (%)
Industrials	21.0	9.3	11.7
Cons Discretionary	18.8	10.4	8.4
Info Technology	11.4	22.2	(10.8)
Financials	10.7	12.9	(2.2)
Healthcare	9.2	13.5	(4.3)
Comm. Services	8.4	10.3	(2.0)
Cons Staples	8.3	7.4	0.9
Materials	5.3	2.7	2.6
Real Estate	4.4	3.4	1.0
Utilities	1.7	3.5	(1.8)
Energy	0.9	4.5	(3.6)
Total	100.0	100.0	

Recent Economic Performance

The story of Japan's post-World War II "economic miracle" is well known. Aided by the protection and support of the U.S. hegemon during the Cold War, the Japanese government adopted an industrial policy focused on trade protectionism, export-promotion and channeling large amounts of cheap private sector savings into corporate investment. By the 1960s, that policy had turned Japan into a model "high-growth/low-cost" nation. Importantly, the government then gradually shifted its support from basic industries to higher value-added industries, moving the economy "up the value chain." Rising efficiency, better quality and a weak yen helped boost exports and growth throughout the period despite the shift to more costly production. Even though growth eventually slowed from the immediate postwar decades, GDP still expanded at an average rate of 4.5% per year during the 1980s.

Figure 3 shows how rapidly Japan's economy expanded during the 1980s. Unfortunately, strong growth and easy financing also produced a bubble in asset prices and excess investment. After stocks and other assets crashed at the end of the 1980s, the economy was left saddled with a large amount of bad debt and reluctant consumers. Growth slowed, and Japanese inflation began its long decline.

Figure 3.



Throughout Japan's "lost decade" of the 1990s and into the 2000s, the economy grew much slower than before, although it didn't entirely stagnate. GDP grew at an average rate of 1.3% in the 1990s and 0.6% in the first decade of the 2000s (Table 2). Japanese growth has staged a modest rebound over the last decade, but it remains slow compared with other developed countries and Japan's own experience.

Table 2.

Japanese Economic Growth by Period
Total GDP and Major Categories
Source: Japan Cabinet Office

	Compound Average Growth Rates (%)				
	1980-1990	1990-2000	2000-2010	2010-2015	2015-2018
Total GDP	**4.5**	**1.3**	**0.6**	**1.0**	**1.1**
Private Consump.	4.1	1.5	0.9	0.6	0.4
Fixed Invest.	5.5	-0.4	-2.2	3.0	1.2
Govt. Consump.	3.5	3.0	1.5	1.4	0.8
Exports	5.8	4.7	4.6	2.5	4.0
Imports	6.3	3.4	2.0	4.7	1.7

Demographics, Debt, and Deflation

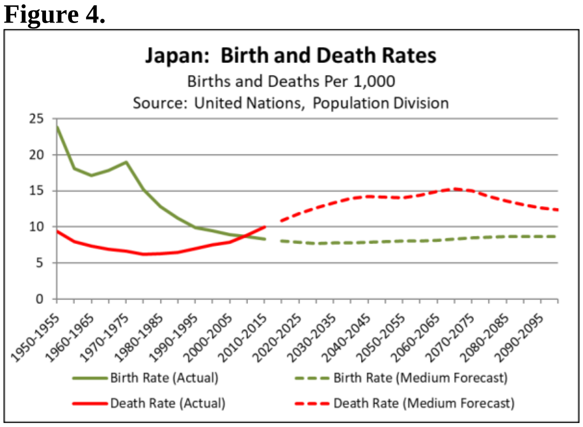
To understand Japan's new VAT hike and its meaning for investors, one needs to keep in mind the dynamics behind Japan's big slowdown since the 1980s. When a country suffers an asset bubble that saddles it with excess capacity and bad debt, it typically has four possible avenues to eliminate its unused capacity and bring the economy back into equilibrium: large-scale war, imperialism, value-chain enhancement or revaluation. Because of its pacifist constitution and the legacy of WWII, the first two options weren't available to Japan. Neither was the third option as the Japanese economy had already transitioned to higher value-added production. By default, the only way for Japan to rebalance its economy was by allowing a decline in the value of Japanese capital assets and debt.

The real question for Japan's rebalancing was how closely the government could or should manage the process. One possibility was the "Austrian" model, which calls for the government to get out of the way and let market forces work, even if it means a sudden, brutal drop in investment and employment. The other possibility was to adopt a more managed, controlled revaluation in which the government tries to slow the process by lowering interest rates, encouraging debts to be rolled over, discouraging layoffs, and the like. The process chosen by Japan was the long, slow version. The Bank of Japan slashed interest rates, helping support asset values, while the government periodically launched fiscal stimulus programs to jumpstart economic activity. In addition, revaluation was delayed by Japan's traditional economic structure, which was built on large, dominant, interlocking corporate networks centered on a core bank (*keiretsu*) and a policy of lifelong employment to maintain labor peace. Those features helped smooth the adjustment process but, as we'll discuss below, several unique headwinds have combined to limit Japan's reacceleration.

As might be expected in a process of asset revaluation and eliminating excess capacity, the key driver behind Japan's post-1989 slowdown was weaker fixed investment. Corporate investment in plant and equipment fell but then rebounded better than expected. That stemmed, in part, from falling interest rates and core banks' support for their *keiretsu* clients. A bigger problem came from a delayed drop in public works spending as the government struggled to adjust to stagnating revenues, rising social security spending and expanding deficits starting in the early 1990s. Investment in private housing fell as the population stopped growing and the average age rose. The second-most important detractor from growth was a slowdown in private consumption spending. In contrast, the growth in Japanese exports has remained fairly steady. As the economy matured, import growth stalled, helping reverse most of the real net export deficits seen during Japan's high-growth period.[1] Now, even as the economy is still recovering from those problems, several unique structural headwinds are holding Japan back:

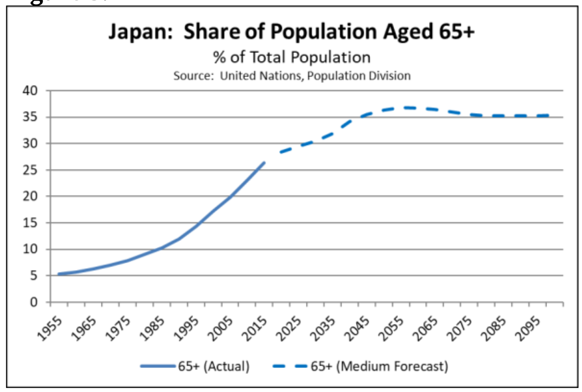
Demographics. Perhaps the biggest headwind exacerbating Japan's excess capacity and slowing its rebound has been a continued, steep decline in the country's birth rate. In fact, Japan's birth rate has recently fallen below its death rate.

Figure 4.



With births insufficient to make up for the number of Japanese who die each year, and with the country's cultural resistance to immigration and strict barriers to new entrants, Japan's population is now falling. Just as important, its average age is rapidly increasing.

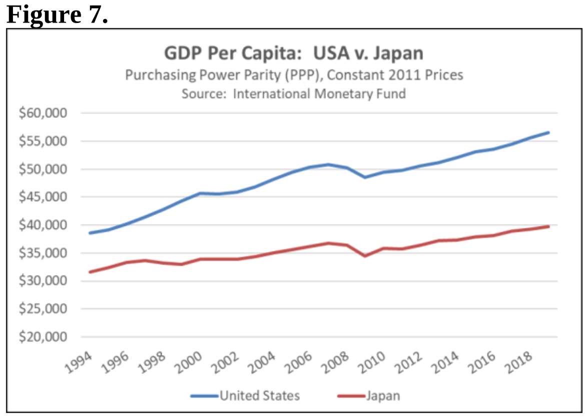
Figure 5.



That has major implications because older workers often find it harder to boost their output over time, which goes far toward explaining Japan's long slide in productivity (Figures 6 and 7).

Figure 6.

Figure 7.

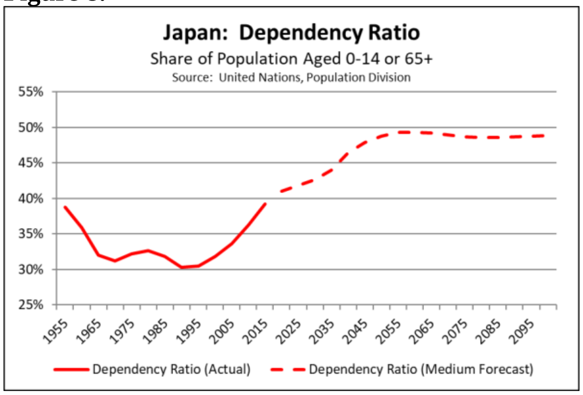


Developed country consumers also typically cut their spending as they approach and enter retirement, which weighs on

[1] In nominal terms, Japan had large trade surpluses from the mid-1980s until about 2010 (most infamously with the U.S.). Since 1989, however, the appreciating yen has forced many exporters to cut prices in order to maintain market share, even as import prices rose slightly. When translated into 2011 prices, the value of prior-year exports goes down and the value of imports goes up, producing a deficit in net exports within the GDP data.

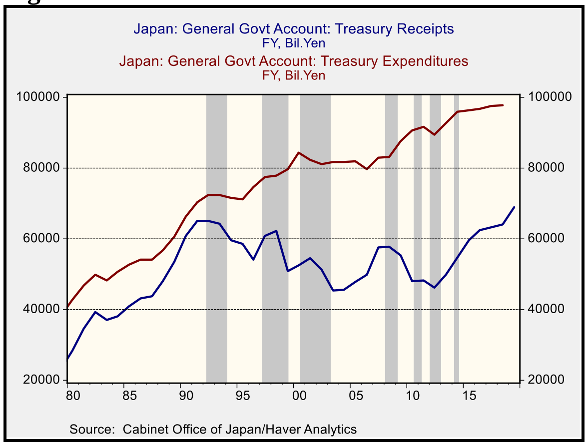
consumption spending and government tax revenues. Finally, Japan's booming population of elderly retirees is boosting the country's "dependency ratio," i.e., the share of the population that is either too young or too old to work (Figure 8).

Figure 8.



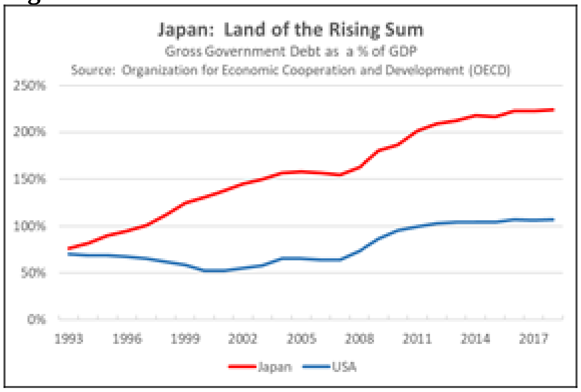
Debt. Even as slower consumption spending weighs on tax receipts, Japan's growing elderly population and rising dependency ratio is boosting social security costs and making it very difficult for the government to control its outlays. Coupled with the earlier fiscal stimulus programs that failed to boost growth, increased social security outlays have produced yawning budget deficits (Figure 9).

Figure 9.



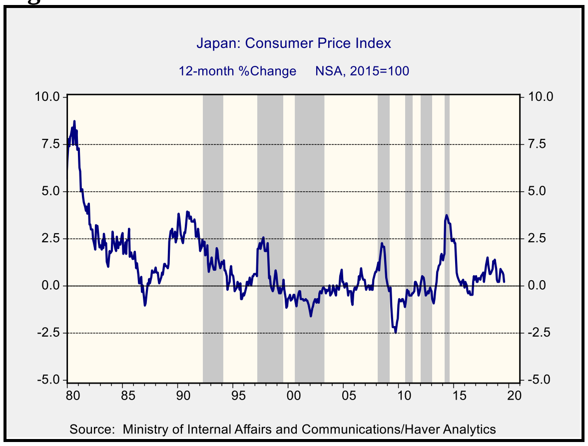
Tax increases and a modest rebound in growth in recent years have helped narrow the deficit, but the cumulative impact of constant deficits over time has pushed total government debt to more than 200% of GDP, far more than the U.S. debt/GDP level (Figure 10). To date, that hasn't undermined investors' willingness to buy Japanese bonds, but the level is high enough that a loss of confidence remains a threat at some point in the future. That, in turn, has prompted the government to limit spending in areas such as public works. The rise in Japan's government debt has more than offset a gradual decline in its corporate and household debt. Japan's total domestic debt therefore stands at a record high of more than 600% of GDP. Likewise, the government's effort to control spending is exacerbating the spending discipline among Japanese companies and households.

Figure 10.



Deflation. A final unique headwind facing Japan is its prolonged bout of disinflation, which has included long periods of outright deflation, i.e., falling prices (Figure 11). Some of the decline in pricing power can be traced to supply-side factors like globalization, deregulation and technological advances. However, we think the main culprit is the weakness in demand associated with an aging population and high debt levels. At the corporate level, weak pricing power weighs on profitability and keeps investment lower than it otherwise would be. At the household level, flat or falling prices can encourage people to put off spending. More broadly, flat or falling prices can translate into weaker income growth and greater difficulty in paying off debt. Disinflation and deflation have been an integral part of the challenging economic environment facing Japan.

Figure 11.



Ramifications

In Part I of this report, we've shown that the Japanese economy has been in a long, prolonged period of low growth and weak prices ever since the bursting of its asset bubble at the end of the 1980s. Economic activity has rebounded to some extent, helped by deliberate policy measures like the central bank's decision to cut interest rates below zero and buy up bonds and stocks. The government has also periodically tried to stimulate growth with loose fiscal policy and heavy public borrowing. Elements of the Japanese economic structure, such as the banks' reluctance to write off their bad loans, have also provided some support for the economy. All the same, we've discussed how growth remains relatively tepid, reflecting both the slow progress in eliminating excess capacity and Japan's unique headwinds of an aging population, high debt levels and deflation. In Part II, we'll take a closer look at the government's economic policy and the reasons for its recent VAT hike. We'll also consider Japan's prospects in the coming years and the ramifications for investors.

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